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STATE FOR EEB (NELSON), EEB/IFD/OMA (WHITTINGTON), DRL/ILCSR AND
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SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON PREL GM
SUBJECT: DIM PICTURE OF ECONOMIC SITUATION IN GERMANY DRAWN BY
INFLUENTIAL ECONOMIC THINK TANK

SUMMARY

¶1. At a conference celebrating the 60th anniversary of the influential Munich-based think-tank, ifo, President Hans-Werner Sinn dueled with German Federal Bank (Bundesbank) President Axel Weber on the outlook for the German economy. Sinn, one of Germany's most influential and most-quoted economists, drew a dim picture of the situation in Germany, anticipating a drastic downturn in GDP and increasing unemployment. He mainly held Germany's extreme export orientation responsible for the steep recession and strongly criticized governmental bailout initiatives. According to Sinn, the overwhelming danger was deflation, not inflation, a point that Weber pointedly disputed. A subsequent panel discussion focused on renewing capital requirements for banks and finding a way out of the ongoing crisis. Later at a private meeting with Embassy and Consulate representatives, Sinn said that only German domestic investments could fill the nation's demand gap. END SUMMARY

No Relief in Sight

¶2. (U) Professor Hans-Werner Sinn opened the conference celebrating the 60th anniversary of the influential think-tank of which he is president, ifo, by painting a dreary picture of the German economy. Although ifo's own widely-recognized economic barometer, the "business climate index," tracked a more optimistic business confidence in June, Sinn did not see significant signs of recovery in what he called the crisis' "epicenter," the U.S. economy. Since the German business cycle tends to lag that of the U.S. by a year-and-a-half, Sinn forecasted that German unemployment would rise dramatically until the end of 2010. He anticipated growth rates of minus 6.3 percent for 2009 and around minus 0.3 percent for 2010.

Exports to blame

¶3. (SBU) Sinn saw Germany's over-dependency on exports as responsible for the country's economic situation. With orders from abroad decreasing by 41 percent, he suggested that Germany had become a "shock absorber" for the international crisis. He explained his theory by saying that in the U.S., China and UK, imports decreased by much more than exports, causing a worldwide drop in demand. Only Germany and Japan, where exports shrank more drastically than imports, helped to compensate for this. (COMMENT: In a subsequent meeting with Sinn, EconMin disputed this assertion, noting shrinking German and Japanese current account deficits, while welcome, had not stimulated world-wide demand. END COMMENT.) Sinn also identified weak domestic investment as a fundamental "mistake in the German business model." With its 4.1 percent net investment quota, Germany is last among all industrial nations. Unable to find

profitable investment opportunities in Germany, capital had flowed to foreign financial markets, and eventually to risky subprime markets, he said. Sinn joked that the U.S. had effectively gambled away German money.

"Bad bank" versus recapitalization

¶4. (U) Bundesbank president Axel Weber did not agree with Sinn on a number of points, including the German government's bank rescue plan. Where Sinn criticized the "bad bank" idea because it was based on the shaky assumption that toxic paper would gain value after the crisis, Weber supported the government's proposed scheme. Getting bad paper off the banks' balance sheets would help them raise new capital in financial markets, he claimed. Sinn instead argued the government had no alternative but to become an active shareholder in stricken banks in order to recapitalize them. At the same time, Sinn did not foresee an increased danger of inflation and, to the apparent irritation of Weber, contended that governments needed to turn on the money spigot to avert a dangerous deflationary spiral. Privately, however, Sinn defended Chancellor Merkel's limited stimulus plan, and he faulted the U.S. stimulus package for seemingly substituting excessive government spending for excessive consumer spending.

Short-term bailouts versus long-term prevention
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¶5. (U) A panel discussion featuring Professor Sinn, Bundesbank President Axel Weber, HypoVereinsbank executive Theodor Weimer, and Bavarian Finance Minister Georg Fahrenschon (CSU) rounded out the event. All participants agreed that strengthening capital

requirements for banks and improving banking supervision were essential to avoid a repetition of the crisis. Fahrenschon and Weber stated that the Basel II recommendations, with their limited capitalization requirement and narrow European scope, were not sufficient. In a new bank supervisory system, the Bundesbank would have to play a key role, Weber said. Weimer added that the timing of new credit requirement legislation was crucial. Increasing capital requirements before a significant recovery from the crisis could cause a credit crunch that would further harm industry. Fahrenschon agreed and pointed out that banks should be pressed to give loans to industry in return for governmental aid, as is the case in Austria. Most of the discussion, however, centered on different bailout models: mandatory capital injections (Sinn) versus bad banks (Weber).

Sinn: More domestic investment and better supervision
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¶6. (SBU) In a private meeting at the Ifo Institute the next day, Sinn told EconMin Robert Pollard, Consul General Nelson, and ConGen Munich staff that only German domestic investments could fill the demand gap. This should occur in tandem with higher savings and investment in the United States. Only investment meant real growth. "Investing in more machines results in higher wages and more consumption," Sinn said, and he recommended the same for the United States. "Americans have been addicted to Champagne," he said. "Foreign credit exporters like Germany paid for the Champagne. Now the government pays." He said it was essential to reduce Wall Street profits and to "make banking boring again." Sinn contended that the German bank supervisor, BaFin, had also failed, particularly in overseeing German banks' international businesses. He added that, although other European countries had done a better job in that respect, European credit requirements in general were insufficient. "Basel II is not tougher than the current American regulations," he said, adding that Basel II was not a meaningful goal for the U.S. or the world. It was important to use today's window of opportunity to increase capital requirements. At the same time politicians needed to do everything possible to avoid a credit crunch. Sinn advocated the recapitalization of stricken banks with increased capital requirements, despite the fact that this would make the bailout more expensive.